SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
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THE YEAR THAT WAS: 1989

The only thing predictable about 1989 was that neither the Chicago Cubs nor the Boston Red Sox would win the World Series. Otherwise, only a gaze into, you know whose, crystal ball may have given us any clues on what was to come.

First on the unpredictable side was OPEC's sudden resurgence in the U.S. capital markets. Supported by higher oil prices, these investors made net purchases of $3.6 billion of equities and over $8 billion in U.S. Treasuries.

Second, activity in 1989 proves that the 1987 market crash did not have a long-term chilling impact on cross-border equity investment.

Third, net overseas equity purchases by U.S. investors totalled almost $13.7 billion in 1989, by far a record high. U.S. holdings of foreign equities now totals close to $100 billion.

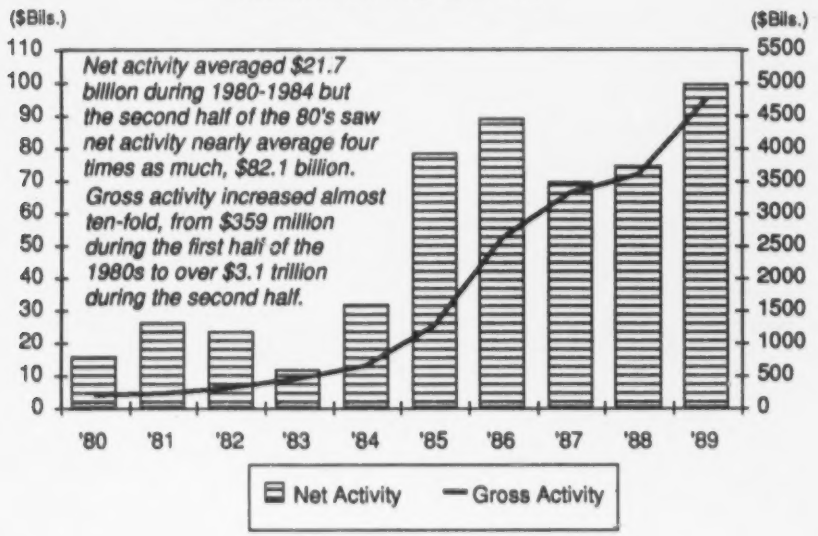
Finally, the theme that developed over the course of 1989 was the increasing amount of capital that will be demanded. The movement toward EC 1992 and changes in Eastern Europe critically alter the supply and demand for capital equation. All other things being equal, the future demand for capital may well exceed the available supply. The impact on global interest rates is an unsettling thought, and the worldwide rise in interest rates may be hard pressed to move back down.

Foreign Investment In U.S. Securities: Not A Bad Way To End A Decade

It has been two and one-half years since the crash of 1987, and, at least in the broadest sense, the crash seems to have had little lasting impact on most foreign investors. For the first time, gross activity in U.S. securities exceeded $4 trillion, reaching $4.8 trillion. Portfolio flows into the U.S. in 1989 neared $100 billion, $99.2 billion to be exact. The 1989 total eclipses the previous high of $88.8 billion in 1986 and far exceeded 1988's inflow of $74.8 billion. As we'll note later, though, worldwide events may make the supply of foreign capital less available to service the U.S. deficit.

However, the foreign investors' preference for U.S. equities continues to lag the 1986 and 1987 levels, when net purchases of U.S. equities accounted for 22% of net foreign flows. In 1989, net equity purchases were about half the size of the 1986-1987 share, or 10.5%.

Portfolio Investment in U.S. Securities Reached New Heights in 1989



What A Difference A Year Makes: Foreign Investors Come "Home"

After making net sales of $2 billion in 1988, foreign investors returned to the U.S. equity market in style. While the year ended on a down note — 4Q89 saw net sales of $400 million — the yearly total of $10.4 billion is the third highest level ever, compared to 1986's record $18.7 billion and 1987's $16.3 billion. Gross transactions in 1989 neared $417 billion, or a quarterly average of $104 billion. While still below 1987's peak of $480 billion, the 1989 total represented a welcome 14.3% increase in transaction volume over 1988's $364 billion. With interest rates declining, stock prices increasing, and the dollar strengthening, many foreign investors were able to put most of their misgivings behind, further strengthening the notion that the 1987 crash did not cause irreparable harm to international investing.

The increased commitment to U.S. equities came from all major geographic regions. Despite keen U.K. interest in U.S. equities, net purchases from Europe totalled slightly over $1 billion, as many European countries showed no interest in acquiring U.S. equities. Investors from France and Germany, concentrating on domestic events, made net sales of $700 million and $865 million, respectively. It didn't hurt that, in local terms, French equities posted a nearly 30% return while German stocks rose over 34% in price.

Investors from Switzerland remained divestors of U.S. equities, making net sales of $1.2 billion in 4Q89, and near $3.5 billion for the year. However, investors from the U.K. more than made up for the European sell-off, making net purchases of $4.5 billion. We suspect that high cash levels among institutions resulting from record levels of M&A activity, the specter of rising U.K. interest rates and a strong U.S. equity market contributed to this surge.

Both Japanese investors and OPEC showed an appetite for U.S. equities. Investors from Japan added an additional $3.3 billion to their U.S. equity portfolios, matching their 1986 total. Share prices in Tokyo increased by nearly 19% (local terms) in 1989 while the Yen weakened over the year, from ¥125 to the dollar to ¥143.8. Domestic political problems and rising Japanese interest rates provided impetus for money to flow to the U.S.

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES BY FOREIGN INVESTORS
($Mils.)

	1988		*1989*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1988-1989*
EUROPE	**$154,152**	**($3,423)**	**$203,790**	**$1,010**	**32.2%**
BELGIUM-LUXEMBOURG	7,738	134	14,044	346	81.5%
FRANCE	12,028	(281)	15,620	95	29.9%
GERMANY	10,966	223	15,747	(592)	43.6%
NETHERLANDS	5,828	(535)	7,387	6	26.8%
SWITZERLAND	34,909	(2,242)	32,934	(3,483)	(5.7%)
UNITED KINGDOM	73,235	(1,034)	97,217	4,507	32.7%
CANADA	**33,941**	**1,088**	**45,397**	**(867)**	**33.8%**
LATIN AMERICA & CARIBBEAN	**38,301**	**1,248**	**61,343**	**3,049**	**60.2%**
BERMUDA	6,663	55	12,701	1,329	90.6%
NETHERLANDS ANTILLES	12,729	385	18,568	744	45.9%
ASIA	**129,624**	**(1,104)**	**97,974**	**6,869**	**(24.4%)**
HONG KONG	6,876	(250)	9,021	139	31.2%
JAPAN	104,601	1,923	60,769	3,255	(41.9%)
OIL EXPORTING COUNTRIES	14,143	(2,466)	23,899	3,591	69.0%
TOTAL ALL COUNTRIES*	**$363,965**	**($2,062)**	**$416,333**	**$10,163**	**14.4%**

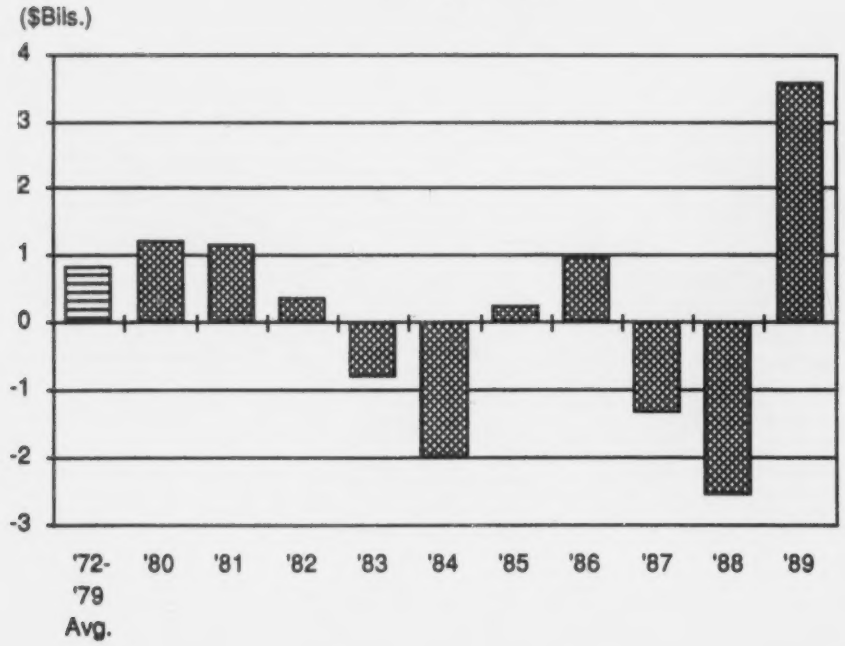
Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

We believe that the relatively small investment by Japanese investors in U.S. equities may be a result of the increased emphasis on direct investment in the U.S., as well as other European investment opportunities. Japanese balance of payments data supports this theory. In 1987, 48% of Japanese net purchases of foreign securities was made in the EC; by the 1H89, this percentage had risen to over two-thirds. In sharp contrast, net investment in U.S. securities by Japanese investors, which accounted for 43% of net flows in 1987, more than halved to just over 20% at the 1H89. Coupled with

the current turmoil in the Tokyo market, capital flows from Japan to the U.S. may be at reduced levels in future years. We suspect that the Tokyo stock market collapse may force Japanese investors to use the strengthening dollar to build Yen cash positions to cover open positions in the home market.

Investors from OPEC, benefiting from higher oil prices and increased demand, made record net purchases of near $3.6 billion, nearly double their 1976 record of $1.8 billion. OPEC's investment marks a sharp reversal from the past two years, when net sales of $4.0 billion were made in response to the collapse in world oil prices. Overall in the 1980s, these investors were net purchasers of over $800 million of U.S. equities; in contrast, OPEC made net purchases of over $6.5 billion during the 1970s.

OPEC Net Purchases Of U.S. Equities Soar To Nearly $3.6 Billion



Swiss investors made net sales in each quarter of 1989 (as well as in 1988) for a total net sales posture of $3.5 billion, their largest yearly divestment ever. The memory of the October 1987 crash seems to have lingered with Swiss investors and the 24% gain in Swiss equity prices in 1989 got the attention of Swiss investors. Starting with the 4Q87, these investors have made net sales for nine consecutive quarters, totalling nearly $7.8 billion. We believe that for the most part, the Swiss have reinvested this money in Swiss securities, particularly fixed-income products. Steadily rising Swiss rates since 1988, most notably on short-term instruments, have given these investors the opportunity to "lock-in" yields with no currency risk. For instance, the three month

deposit rate, which averaged 1.5% in 1Q88, averaged 7.5% in 4Q89. With Swiss investors still troubled by the events of October 1987, high domestic interest rates and events in Germany only compounded the negative posture these investors have taken in the U.S. equity market and may auger a smaller Swiss role in the U.S. equity markets.

While waiting for a firm trend to develop, the emergence of an integrated European common market and the market-reform policies of Eastern Europe may displace flows otherwise earmarked for U.S. equities. We note two examples. First, the record number of European merger and acquisitions resulting from the need to enhance competitiveness come 1992 have almost certainly siphoned European funds ordinarily invested in the U.S. market. According to one recent study (Translink's European Deal Review), European M&A activity was near $52 billion in 1989, with the most active acquiring companies from Europe located in the U.K., France, West Germany and Italy.

Second, the substantial foreign flows into the West German securities markets, with net equity purchases totalling over a record $12 billion in 1989, also indicate foreign investor interest in playing the "Eastern Europe Card". Moreover, German investors will likely supply less capital abroad as they concentrate on rebuilding East Germany, where estimates as high as $500 billion have been put on the rebuilding of this country. Recent ventures, such as Deutsche Bank's acquisition of an East German Bank's branch network, underscore this point. In the 1990s, these new investing opportunities and obligations may lessen the support that foreign investors give to the U.S. equity markets specifically, and securities markets generally.

For instance, continued growth in the emerging markets could also attract capital. A recent study by The World Institute For Development Economics Research estimates that by the end of the century, foreign investment in emerging markets markets could increase by over six-fold; from $15 billion in 1989 to $100 billion in the year 2000.

And, given the need for capital in Europe, the available supply of foreign capital for the U.S. does not seem to be keeping pace with a growing demand. That other nations are now in need of enormous capital infusions should concern U.S. policy makers legislating proposals affecting foreign capital.

U.S. Treasuries: Foreign Investment Moves To Another Level

In 4Q89, gross activity dipped to $1 trillion, down from the record $1.1 trillion in 3Q89, while net purchases reached $7.3 billion. The 4Q89 totals pushed both gross and net activity to records levels, $4.1 trillion and $54.5 billion, respectively. Net purchases by foreign investors accounted for over 50% of the year-to-year increase in Treasury bonds and notes outstanding, while trading activity was equivalent to over 14% of the activity of U.S. primary dealers.

The private sector made record net purchases of $25.8 billion in 1989, topping the

previous high of $21.5 billion reached in 1988. Declining U.S. interest rates, a stable to increasing dollar, and worldwide political change made U.S. Treasuries particularly attractive in 1989. Official institutions (central banks) made net additions of $26.9 billion, a slight gain over the previous year's $26.6 billion.

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. TREASURY NOTES AND BONDS BY FOREIGN INVESTORS
($Mils.)

	1988		*1989*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1988-1989*
EUROPE	**$1,163,593**	**$14,255**	**$1,557,059**	**$36,217**	**33.8%**
GERMANY	79,706	(5,348)	57,199	7,913	(28.2%)
SWITZERLAND	24,487	(1,074)	30,047	2,200	22.7%
UNITED KINGDOM	798,901	9,667	1,106,140	20,425	38.5%
ASIA	**$1,457,103**	**$27,357**	**$2,198,065**	**$13,913**	**50.9%**
JAPAN	1,238,009	21,753	1,886,989	2,311	52.4%
"OTHER ASIA"	81,370	1,715	115,288	8,501	41.7%
NONMONETARY INT'L & REGIONAL ORGANIZATIONS	**$246,117**	**$686**	**$148,045**	**$2,171**	**(39.8%)**
TOTAL ALL COUNTRIES*	**$3,083,732**	**$48,529**	**$4,121,818**	**$54,525**	**33.7%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

The most interesting story in this market is the return of OPEC investors to U.S. Treasuries. Despite a sell-off of $2.6 billion in 4Q89, OPEC net purchases of Treasuries totalled $8.5 billion for the year. Not surprisingly, the flows into the U.S. have coincided with OPEC's slightly improving trade balance with the U.S. This increase in capital flows from OPEC to the U.S. market, may to some extent, replace those flows from Japanese and European investors which have been re-directed to Europe.

U.S. Investment In Foreign Equities: The Wave Of The Future?

As noted in an earlier issue of *FAR*, U.S. investors were star performers last year. With a strengthening U.S. dollar easing the way, political and economic transformations around the world, particularly in Europe, led U.S. investors to make net purchases of a record $13.7 billion. Moreover, gross transactions in 1989 totalled a record $220 billion, a 16% increase over 1987's record $190 billion, and an impressive 45.7% increase over 1988's $150.8 billion. In sharp contrast, volume on the NYSE increased only 2.7%.

Buoyed by European events, U.S. investors made net commitments of over $10.5 billion to European equities markets; of this, $8.9 billion went to the EC. And why not.

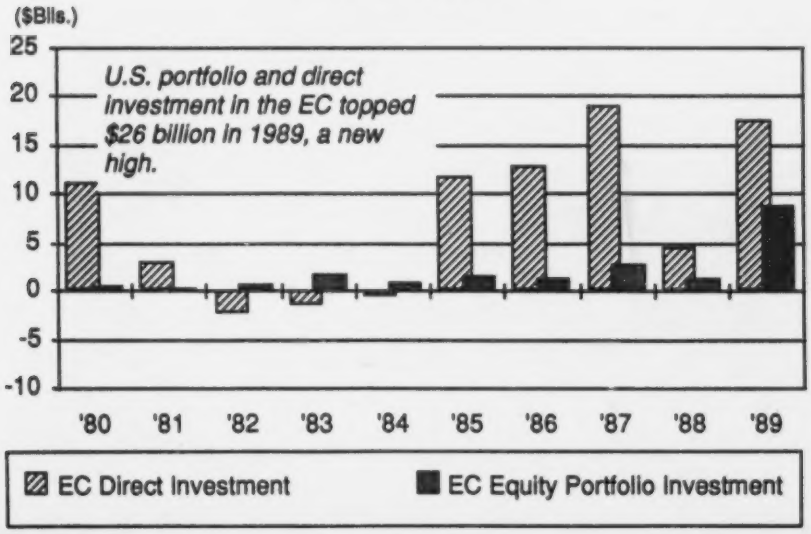
GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($Mils.)

	1988		*1989*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1988-1989*
EUROPE	**$75,445**	**$1,279**	**$116,789**	**$10,531**	**54.8%**
FRANCE	4,008	402	6,497	1,115	62.1%
GERMANY	4,525	239	6,215	861	37.3%
NETHERLANDS	3,974	(206)	6,051	1,213	52.3%
SWITZERLAND	5,309	521	7,913	1,381	49.0%
UNITED KINGDOM	51,213	403	79,694	4,642	55.6%
CANADA	**9,845**	**(477)**	**10,839**	**1,271**	**12.4%**
ASIA	**55,846**	**822**	**75,707**	**825**	**35.6%**
JAPAN	40,158	634	65,748	1,044	63.7%
OTHER	**9,906**	**(110)**	**14,531**	**1,039**	**46.7%**
TOTAL ALL COUNTRIES*	**$150,842**	**$1,514**	**$219,791**	**$13,683**	**45.7%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Returns (U.S. dollar terms) in Europe exceeded 24% for the year, with France showing a 35.6% return and Germany, a 40.7% gain. Indeed, both these countries experienced record U.S. equity inflows during 1989, as U.S. investment in French equities totalled

U.S. Direct And Portfolio Investment In The EC



$1.1 billion while German investment totalled $831 million. Underscoring the interest in these two countries is interest in these markets by all foreign investors. German shares were the recipients of net equity inflows of over DM23 billion, over 55% greater than 1986's DM15 billion. In France, portfolio investment in 1989 reached FFr190.6 billion, almost triple the previous year.

The real disappointment for U.S. investors must have been their $1 billion commitment to the Tokyo equity markets. U.S. investors saw returns (U.S. dollars) on their Japanese investment rise a lackluster 3%. Furthermore, we note that the double-barraled impact of declining equity prices and a weakening Yen reduced the value of U.S. investors' Japanese equity investments, in U.S. dollar terms, by over 35% during the first quarter of 1990.

David G. Strongin
Director, International Finance

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS BY FOREIGN INVESTORS
($Mils.)

	1988		1989		% CHANGE IN GA 1988-1989
	GROSS ACTIVITY	NET PURCHASES	GROSS ACTIVITY	NET PURCHASES	
EUROPE	**$51,830**	**$15,149**	**$67,299**	**$13,637**	**29.8%**
BELGIUM-LUXEMBOURG	2,104	(171)	2,976	(1,212)	41.4%
FRANCE	2,334	75	2,447	467	4.8%
GERMANY	4,053	990	3,680	(50)	(9.2%)
SWITZERLAND	3,740	346	3,868	(38)	3.4%
UNITED KINGDOM	35,226	12,452	49,209	13,149	39.7%
ASIA	**24,964**	**5,068**	**32,412**	**2,060**	**29.8%**
JAPAN	24,330	4,864	25,734	786	5.8%
"OTHER ASIA"	2,226	(204)	3,711	1,045	66.7%
TOTAL ALL COUNTRIES*	**$87,702**	**$21,914**	**$117,885**	**$19,497**	**34.4%**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions